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IN THE

Supreme Court of the United States

NO. 263 TERM, 194..

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

A. L. Lusthaus, petitioner above named, respectfully petitions your Honorable Court that a writ of certiorari issue to review the decision and order of the United States Circuit Court of Appeals for the Third Circuit entered April 11, 1945, affirming a decision of the Tax Court of the United States entered March 29, 1944, in favor of the respondent and against the petitioner.

Opinions Below.

The opinion of the Tax Court of the United States is printed at pages 86 a to 92 a of the record, and is reported at 3 T.C. 540. The opinion of the Circuit Court of Appeals is printed in the record (pages 95 a to 109 a).

It is reported in 149 Fed. (2d) 232. The dissenting opinion of District Judge Fake is also printed in the record (pages 99 a to 109 a).

Jurisdiction.

The decision of the Circuit Court of Appeals was entered April 11, 1945. A petition for rehearing was filed April 25, 1945. Rehearing was denied May 28, 1945, and an order was entered on the same date. The jurisdiction of the Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938 (Section 347 of Title 28 U.S.C.A.).

Statutes and Regulations Involved.

The statutes and regulations here involved may be found in the Appendix, *infra*, pages 17 to 18.

Questions Presented.

1. Where a husband and wife form a partnership for the conduct of a business requiring substantial capital, to which the wife makes a capital contribution of property owned by her and under local law her property and contract rights as a partner are fully recognized, can such partnership status and the individual property interests of the partners, as established by law, be entirely disregarded for income tax purposes?

2. Where a husband makes a gift of money to his wife upon condition that it be used to purchase from him an undivided interest in the assets of a furniture business owned by him and that she will thereafter con-

tribute such interest to the capital of a partnership to be formed with him for the conduct of the business and such conditions are fulfilled, can it be inferred from such facts and circumstances that no change in economic interests resulted and the wife acquired no separate property interest of her own, or do such facts evidence, as a matter of law, a valid and complete gift vesting title in the wife?

3. Is there any evidence in the record legally sufficient to warrant the Tax Court's determination that the property transfers made and the legal partnership formed between petitioner and his wife were fictitious and unreal and should be given no recognition for federal income tax purposes?

4. Is the decision of the Tax Court based on a mistake of law?

Statement.

Petitioner for many years was the owner of and operated a retail furniture business consisting of two stores, both in Uniontown, Pennsyylvania (R. 4 a). Lillian Lusthaus, his wife, had at all times prior to 1940 assisted petitioner in his stores and she continued in that practice at all times here involved (R. 41 a). She received no salary at any time. Apart from the gift of $50,000 hereinafter referred to, petitioner's wife had a separate estate valued at at least $45,000 (R. 34 a).

Petitioner and his wife agreed that petitioner should sell to her a one-half interest in his business for $105,000, effective January 1, 1940, and that they should become partners and thereafter conduct the business as a partnership (R. 5 a-7 a). The net worth of the busi-

ness as of January 1, 1940, was determined to be approximately $210,000 (R. 6 a). Petitioner made a gift to his wife of $50,000 (R. 18 a) and filed a gift tax return thereon (R. 17 a). Petitioner then executed and delivered to his wife a bill of sale for an undivided one-half interest in his furniture business for a consideration of $105,253.81 (R. 11 a). Mrs. Lusthaus gave to petitioner her personal check for $50,253.81 (R. 11 a), together with eleven promissory notes totalling $55,000, payable in one to eleven years from date, respectively, thus accounting for the full purchase price. These notes have been paid by her as they matured (R. 12 a).

The parties complied with the law of Pennsylvania in registering under the Fictitious Names Act of the Commonwealth of Pennsylvania (R. 56 a-57 a). Partnership books were opened as of January 1, 1940 (R. 10 a), and thereafter the profits of the partnership were equally divided between the partners on the books of account and each partner made withdrawals therefrom and made deposits in their respective individual accounts (R. 44 a-48 a). The income tax returns for 1940 and subsequent years were filed as partnership returns (R. 45 a). Litigation was brought in the partnership name. Through oversight (R. 29 a) the bank was not notified to honor the wife's signature on partnership checks until 1943. Continuing office practice, social security tax returns as prepared by the bookkeeper were executed by petitioner as "owner" until June of 1941 (R. 27 a). The character and extent of Mrs. Lusthaus' services in the business were not changed after the formation of the partnership (R. 41 a). The partnership was formed after consultation with accountants and counsel (R. 52 a) and the legal formalities suggested by counsel were complied with. It appears to be conceded

and is a fact that capital is a material income producing factor in the furniture business here involved. Balance sheets appear as exhibits (R. 78 a-81 a).

The decision of the Tax Court of the United States upheld the right of the Commissioner of Internal Revenue to include as a part of petitioner's gross income all of the profit of said furniture business for 1940 and affirmed his determination of an income tax deficiency of $22,419.98 for said year.

On these facts the Tax Court said as follows (R. 90 a):

> "The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes."

The Tax Court further said (R. 91 a):

> "The wife acquired no separate interest of her own by turning back to petitioner the $50,000 which he had given her conditionally and for that specific purpose."

Upon review the Circuit Court of Appeals considered such conclusions as factual conclusions which could be inferred from the evidence and which it as the reviewing court was not at liberty to reweigh and was required to accept. The majority opinion states as follows:

> "The one real problem is whether there was substantial evidence to support the Tax Court's conclusion. If there was, then we are not at liberty to reweigh the evidence or choose between conflicting inferences." (page 98 a)

The opinion further said:

"It could be inferred from the evidence that there was no real contribution of capital by Mrs. Lusthaus. The circumstances surrounding the $50,000 incident, with the money immediately returned to the petitioner, could be construed as indicating that the latter had not divested himself irrevocably of the subject matter of the gift."

On April 11, 1945, the decision of the Tax Court was affirmed by the Circuit Court of Appeals. Plaintiff's petition for a rehearing was denied on May 28, 1945.

One judge vigorously and logically dissented (R. 99 a).

Reasons for Granting the Writ.

1. The decision of the Third Circuit Court of Appeals in affirming the decision of the Tax Court of the United States conflicts in principle with applicable decisions of this Court which have announced and have adhered to the principle that in the application of a federal revenue act state law controls in determining the nature of the legal interest which a taxpayer has in the property or income sought to be reached by the statute. See *Poe v. Seaborn,* 282 U. S. 101; *Erie Railroad Company v. Tompkins,* 304 U. S. 67, at page 78; *Morgan v. Commissioner,* 309 U. S. 78, at page 82; *Helvering v. Stuart,* 317 U. S. 154, at page 161.

The decision of the Tax Court, as affirmed by the Circuit Court of Appeals, states that the "formalities" engaged in by the parties "did not change petitioner's economic interest in the business." (R. 91 a) It states further that the wife "acquired no separate interest of

her own by turning back to petitioner the $50,000 which he gave her conditionally and for that specific purpose," (R. 91 a) and concludes that whether or not the arrangements made constitute a valid partnership under the laws of Pennsylvania "we do not think it should be given recognition for income tax purposes." (R. 92 a) It is submitted that such findings evidence a clear-cut mistake of law in the failure of the Tax Court to recognize and apply the principles announced in the cases above cited.

The uncontradicted facts in the record disclose that under Pennsylvania law petitioner's wife by gift and bill of sale became the legal owner of one-half interest in the assets of a business formerly owned by her husband and in which theretofore she had had no interest or title whatsoever. Under Pennsylvania law, and under general law there was of necessity a change in the economic interests of the parties. The wife became liable for all the debts of the partnership, even to the extent of her other assets.

The Circuit Court of Appeals, in affirming the decision of the Tax Court, has decided an important question of federal law in direct conflict with the established principle announced by this Court that the existence of a relationship or of a legal interest in property as established by local law and by common law rules of property must be recognized in the application of the federal revenue act. In so doing, it has departed from the principles laid down by the Court in *Dobson v. Commissioner*, 320 U. S. 489, and *Trust U/W of Bingham v. Commissioner*, decided June 4, 1945, that a "clear-cut mistake of law" made by the Tax Court requires its reversal.

The basic error of the Circuit Court of Appeals lies in its failure to distinguish between (1) its *right to disregard* for income tax purposes the *terms of any agreement which undertakes to allocate or assign income* to a person who does not produce it or own the property of which it is the fruit, and (2) its *duty to recognize* for income tax purposes a status or *legal interest* created under local law and by common law rules of property.

Conceding the fact that the partnership business in this case is such that capital is a material income producing factor and that petitioner's wife was the legal owner of a partnership interest, it follows as a necessary legal conclusion that *complete* disregard of her property rights as a partner is also in direct conflict with the applicable decision of this Court in *Blair v. Commissioner*, 300 U.S. 5, 81 L. Ed. 465. It is possible that the Tax Court on the facts of a given case would be justified in finding a *partial assignment* of income reflected in the terms of a partnership agreement making profit distribution among the legal partners, but *complete disregard of the legal property interests of the partners and the arbitrary allocation of all income to one partner is a clear abandonment of the fundamental principles of law announced by this Court.* Such a decision is "not in accordance with law."

It is respectfully submitted that the Circuit Court of Appeals, without doing violence to applicable decisions of this Court, cannot arbitrarily allocate to the petitioner for income tax purposes *that portion of the partnership income* which was produced by and resulted from the capital investment of his wife. Common law

rules of property and the applicable decisions of this Court preclude such a decision.

If the petitioner's wife was the owner of an interest in partnership property contributing to partnership income, the determination of the Commissioner allocating *all* of such income to the petitioner and declaring a deficiency in tax is in error under the principles announced in *Helvering v. Taylor,* 293 U.S. 507, in that such decision is without rational foundation and is necessarily excessive.

2. The decision of the Third Circuit Court of Appeals affirming the decision of the Tax Court is in direct conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Francis E. Tower v. Commissioner,* 148 Fed. (2d) 388, decided April 2, 1945 (3 T.C. 396).

The taxpayer in that case made a gift of corporate shares to his wife upon the understanding that the corporation would be dissolved and that she would thus be able to contribute to the capital of a new partnership to be formed with him for the further conduct of the business. The Tax Court sustained the Commissioner in the inclusion in taxpayer's income of all amounts of the partnership earnings withdrawn by or credited to the wife. This decision was based upon the theory that the taxpayer did not relinquish control of the stock transferred since it was transferred subject to the condition that the assets which it represented should constitute her contribution to a partnership to be formed. It was held that because of the condition attached to it the transfer did not constitute a valid and complete gift and hence no contribution to partnership capital was made.

The Circuit Court of Appeals, in reversing the Tax Court and remanding the case for further proceedings, cites *Edson v. Lucas,* 40 Fed. (2d) 398, and holds as follows:

> "Granted, however, that because of the condition, Tower's gift was not complete at the time he gave the shares to his wife, the condition was almost immediately performed. The gift was then both valid and complete, vesting title in the wife to the corporation assets contributed by her to the partnership capital."

In the *Tower* case the Court accepted as a necessary conclusion of law the sufficiency of the gift made by the husband and the actuality of the contribution made by the wife to the partnership capital and, with that basic and otherwise controlling premise, examined the evidence to see whether or not it contained "other facts" sufficient in law to justify the finding that the presumptively valid gift of corporate shares and the capital contribution to the partnership were unreal and a mere artifice. Reviewing the testimony, the Court determined that there was no evidence in the record upon which to base such a conclusion and cited the established principle that factual determinations must be supported by evidence and that administrative decisions must have "warrant in the record."

In the instant case it is quite clear that the Circuit Court approached its review of the Tax Court's decision upon a totally different and conflicting theory of the applicable law. The opinion of the Circuit Court of Appeals expressly states that "the one real problem is whether there was substantial evidence to support the Tax Court's conclusion" (page 98 a) and further that it

"could be inferred that there was no real contribution of capital by Mrs. Lusthaus" (page 98 a) and that "the circumstances surrounding the $50,000 incident * * * could be construed" as indicating that the petitioner had not divested himself irrevocably of the subject matter of the gift (page 98 a).

It is implicit in the language of the decision that the Circuit Court of Appeals in the instant case accepted and adopted the reasoning of the Tax Court that *the condition* attached to the gift made by petitioner to his wife *was a circumstance which could be considered as justifying its factual conclusion that petitioner had not irrevocably divested himself of the subject matter of the gift and that no change in economic interest resulted by reason thereof.* It seems quite clear from the opinion that it is based almost in its entirety upon the premise that petitioner's wife made no real contribution of capital *because the gift of $50,000 made to her upon condition,* did not vest in her the title thereto and the ownership thereof. Aside from the alleged incompleteness of the gift made by petitioner to his wife, neither the Tax Court's opinion nor the opinion of the Circuit Court of Appeals points to any evidence which under the approved standards would be legally sufficient to justify the finding that the gift in question and the partnership in question were not bona fide or were a mere sham.

These two decisions are factually similar in that each involves what in substance is the gift of a partnership interest by a husband to a wife. In the *Tower* case there is involved the preliminary gift of corporate stock upon agreement that following dissolution the corporate assets will become partnership capital; whereas in the instant case there is the gift of cash upon the agreement

that the cash will be used to purchase assets of a business which in turn shall constitute capital of a partnership to be formed.

The basic issue involved in both of these cases is whether in an income tax case the circumstances surrounding a gift by a husband to his wife and the acquisition by her of a partnership interest in his business raise *questions of fact* from which artifice, sham and *mala fides* can be inferred or whether the *legal consequences of what was done* by the parties under general and local law must be accepted as establishing their legal rights, titles and interest and their legal liabilities. The federal law must be applied accordingly.

The Sixth Circuit Court of Appeals in the *Tower* case, *supra,* says, in effect, we accept the vesting of a legal property interest as a matter of law and in the "other evidence" find no artifice or sham.

The Third Circuit Court of Appeals in the instant case says, in effect, one *could infer from the fact that a condition was attached* to the gift, that it lacked reality, passed no legal interest and was insufficient to divest the donor of control of the subject matter; the Tax Court has so found as a fact and we are not at liberty to reweigh the evidence, citing *Dobson v. Commissioner,* 320 U.S. 489.

The Third Circuit Court of Appeals in the instant case has arbitrarily substituted for a necessary legal conclusion a faetual conclusion directly at variance therewith, a "clear-cut mistake of law."

3. The whole problem of family partnerships is of the greatest importance at this time. The public has

been assured that tax liability may properly be minimized by rearrangement of one's business affairs to that end and that the legal and actual owner of income producing property is entitled to the "fruit" it produces and is taxable thereon.

Literally thousands of taxpayers have readjusted their property interests and business methods in reliance upon these fundamental principles of law. The Commissioner of Internal Revenue, upon the apparent theory that blanket condemnation of a family partnership is a substitute for scrutiny and analysis, has, almost uniformly, refused to recognize such partnerships for income tax purposes. The result has been numerous appeals to the Tax Court of the United States and a flood of Tax Court decisions based upon a miscellany of conflicting theories that spell complete confusion and chaos. No standard of measurement has been given to the taxpayer except the unpredictable agreement or disagreement of the Court as a factual determination, that a transaction should or should not be given tax effect.

Since the decision of the Tax Court in the instant case it has rendered numerous decisions in which the circumstances surrounding the making of gifts to a wife have been considered as determinative of the validity of a family partnership. Following two decisions favorable to the Commissioner on the theory that the gifts were incomplete[1], four published decisions were entered

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[1] *O. William Lowry v. Commissioner*, 3 T.C. 730 (on appeal 6 C.C.A.), and *F. J. Lorenz v. Commissioner*, 3 T.C. 746 (affirmed per curiam 148 Fed. (2d) 528, April 13, 1945, 6 C.C.A.).

recognizing the validity of gifts and were acquiesced in by the Commissioner.[2] In all these cases capital was an income producing factor.

At this point it appeared that some pattern was being adopted for the guidance of the taxpayer, and this belief was confirmed when on April 2, 1945, the Circuit Court of Appeals of the Sixth Circuit reversed the Tax Court's decision in the *Tower* case, *supra*. However, on April 11, 1945, the decision in the instant case was handed down, in direct conflict with the decision in the *Tower* case, and the whole issue was again in confusion.

Further confusion has resulted from more recent decisions[3] of the Tax Court involving the same issue and which, supporting the Commissioner's contentions, appear to overrule its prior decisions. In nearly every instance dissenting opinions were filed or dissents registered. Some of these more recent decisions reject the gift theory and rely upon the "equitable assignment" of income principles announced by this Court in *Lucas v. Earl*, 281 U.S. 111, and *Burnet v. Leininger*, 285 U.S. 136.

In other decisions of The Tax Court of the United States the principles urged in the instant case were given recognition.[4] In the *Thorrez* decision[3] there were

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[2] *Sherrer v. Commissioner*, 3 T.C. 776; *Johnson v. Commissioner*, 3 T.C. 799; *Smith v. Commissioner*, 3 T.C. 894; *Zukaitis v. Commissioner*, 3 T.C. 814.

[3] *Thorrez v. Commissioner*, entered May 21, 1945, 5 T.C. . . . (C.C.H., Dec. 14560); *DeKorse v. Commissioner*, entered May 22, 1945 (C.C.H., Dec. 14563); *Carl P. Munter v. Commissioner*, entered May 16, 1945, 5 T.C. . . . . (C.C.H., Dec. 14555).

[4] *D. H. McEachern v. Commissioner*, entered May 7, 1945, 5 T.C. . . . . (C.C.H., Dec. . . . .).

six dissents, with three separate dissenting opinions. In a concurring opinion Judge Mellot states that the result of the efforts of the various Circuit Courts of Appeals and The Tax Court to find the "correct rule," in the absence of any pronouncement by the Supreme Court upon the subject "has not been entirely satisfactory." His opinion is entered in the hope of "dispelling the fog of uncertainty."

In the instant case the vigorous dissent of District Judge Fake not only states very well the principles of law properly applicable in family partnership cases, but also points out the importance to taxpayers generally of establishing some definite standards for measuring the validity and effect of a gift by a husband to his wife of a property interest in his business and its assets.

It is important in the administration of the revenue acts, both to the Treasury Department and to the taxpaying citizens, that the conflict herein discussed should be clarified and that some degree of uniformity in treatment of this type of case should be adopted. Petitioner believes that the matter here presented is one of public interest and importance affecting the conduct of business throughout the United States. The wide publicity and comment which this subject of family partnerships and which the instant decision, as apparently in conflict with the decision in the *Tower* case, *supra,* has had in legal, tax and business periodicals* will attest its public interest and importance.

** American Bar Association Journal,* "Family Partnerships," page 322, June, 1945.

Commerce Clearing House 1945 Rewrite Bulletin, No. 27, paragraph 8414, May 9, 1945.

Ibid., No. 28, paragraph 8420, June 27, 1945.

Conclusion.

For the foregoing reasons it is respectfully submitted that this petition should be granted and that writ of certiorari should issue to the Circuit Court of Appeals for the Third Circuit.

Respectfully submitted,

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Estate and Tax News, Reprint of "That Family Partnership Quarrel," page 552, June, 1945 (material copyright Prentice Hall, Inc.).

George Washington Law Review, "The Partnership in Tax Avoidance," by Randolph Paul, page ...., February, 1945, condensed digest in *Taxes*, page 552, June, 1945.

Prentice Hall, *Current Commentary Report*, No. 23, paragraph 70526.

APPENDIX.

Statutes Involved.

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political sub-division thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 1940 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U. S. C. 1940 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. (26 U. S. C. 1940 ed., Sec. 3797.)